

**Office of Chief Counsel  
Internal Revenue Service  
memorandum**

CC:INTL:BR1:JSHenderson  
POCAT-145074-06

date: May 13, 2009

to: David Marion  
Manager, Tax Treaty Group  
Attn: Patrick Orzel

from: M. Grace Fleeman  
Senior Technical Reviewer CC:INTL:BR1

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subject: [REDACTED]  
Taxation of Department of Veterans Affairs Disability Compensation  
United States - Germany Income Tax Treaty

This memorandum responds to a request submitted by Patrick Orzel (Competent Authority Analyst, SE:LM:IN:T:1) concerning the proper tax treatment of U.S. Department of Veterans Affairs disability compensation payments ("disability payments") under Article 19 (Government Service) and Article 23 (Relief from Double Taxation) of the United States - Germany Income Tax Treaty ("the Treaty").<sup>1</sup>

### **Facts**

[REDACTED] is a U.S. citizen who is also a resident of Germany pursuant to Article 4(1) of the Treaty. [REDACTED] receives his disability payments to compensate him for injuries related to his service in the U.S. Army. We have no information as to where or when his services were performed. The payments are exempt from U.S. income tax pursuant to section 104(a) of the Internal Revenue Code. Germany exempts the disability payments from tax pursuant to Article 19(1)(a) of the Treaty, but takes them into account for purposes of the progression clause in Article 23 of the Treaty. Consequently, the disability payments are not taxed in either country, but are taken into account to determine the German income tax rate imposed on [REDACTED] income that is taxed by Germany.

### **Issue**

May Germany may take [REDACTED] disability payments into account to determine the

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<sup>1</sup> Convention Between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, signed on August 29, 1989, as amended by the Protocol signed on June 1, 2006, *reprinted* in 2 Tax Treaties (CCH) ¶ 3203.

rate of taxation on his income that is subject to tax in Germany?

### Conclusion

Pursuant to Article 23 of the Treaty, [REDACTED] disability payments may be taken into account by Germany to determine the rate of taxation on his income that is subject to taxation in Germany.

### Analysis

Because [REDACTED] is a resident of Germany pursuant to Article 4(1) of the Treaty, the correct German tax treatment of his disability payments is determined under Article 23 of the Treaty.

Article 23(3) of the Treaty provides that

[w]here a resident of the Federal Republic of Germany derives income or capital which, in accordance with the provisions of this Convention may be taxed in the United States . . . tax shall be determined as follows:

(a) [e]xcept as provided in subparagraph b), the income or capital shall be excluded from the basis upon which German tax is imposed. The Federal Republic of Germany, however, retains the right to take into account in the determination of its rate of tax items of income and capital excluded under the provisions of this Convention.<sup>2</sup>

Germany's tax treatment of [REDACTED] disability payments pursuant to Article 23(3)(a) of the Treaty is correct only if those payments may be taxed by the United States pursuant to the Treaty.

Whether [REDACTED] disability payments are properly taxable by the United States in accordance with the provisions of the Treaty is determined under Article 19 of the Treaty. Article 19(1)(a) of the Treaty provides that

salaries, wages, and other similar remuneration, other than a pension, paid by a Contracting State . . . to an individual in respect of services rendered to that Contracting State . . . shall, subject to the provisions of subparagraph b), be taxable only in that State.<sup>3</sup>

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<sup>2</sup> Article 23(3)(b) of the Treaty sets out those items of income that may be taxed by the United States pursuant to the Treaty and for which Germany will allow a foreign tax credit. [REDACTED] disability payments are not within the scope of Article 23(3)(b) of the Treaty. Consequently, the correct German tax treatment of his disability payments is determined under Article 23(3)(a) of the Treaty.

<sup>3</sup> No one has asserted that [REDACTED] disability payments are a "pension" and, therefore, outside the scope of Article 19(1)(a) of the Treaty.

Consequently, the disability payments are taxable solely by the United States and are exempt from tax by Germany, unless Article 19(1)(b) of the Treaty provides otherwise. Under Article 19(1)(b) of the Treaty, the disability payments are taxable solely by Germany (and are not taxable by the United States) only if:

- (i) [REDACTED] U.S. Army services were rendered in Germany;
- (ii) [REDACTED] is a resident of Germany; and
- (iii) [REDACTED] did not become a resident of Germany solely for the purpose of rendering his U.S. Army services.

Germany has not asserted exclusive taxing authority over [REDACTED] disability payments pursuant to Article 19(1)(b) of the Treaty. Furthermore, Germany has not asserted taxing authority over the disability payments pursuant to any other Treaty article.

Germany exempts [REDACTED] disability payments from German taxation pursuant to Article 23(3)(a) of the Treaty, thereby recognizing the right of the United States to tax [REDACTED] disability payments pursuant to Article 19(1)(a) of the Treaty. Germany also takes the disability payments into account pursuant to Article 23(3)(a) to determine the German income tax rate applicable to [REDACTED] income that may be taxed by Germany. Therefore, Germany is applying the Treaty correctly with respect to [REDACTED] disability payments.

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The issue in this case was presented by [REDACTED] rather than the German Competent Authority. It is possible [REDACTED] may raise the issue with the German Competent Authority. This memorandum sets out how we would respond if Germany directly asked whether the United States agrees with Germany's application of Article 23(3)(a). Please do not share this memorandum with [REDACTED].

If you have any questions concerning this memorandum, please contact Joseph Henderson at (202) 622-3446.

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